

Internal Revenue Service  
**memorandum**

CC:TL-N-10344-89

VWATERS

date: DEC 19 1989

to: District Counsel, San Jose W:SJ  
Attn: Steven A. Wilson

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED]

This is in response to your September 21, 1989, request for tax litigation advice regarding the above-mentioned subject.

ISSUE

1. Whether a grantor trust which is revocable should be disregarded for purposes of determining whether a partnership qualifies as a small partnership pursuant to I.R.C. § 6231(a)(1)(B)?

2. Whether a revenue agent must conduct a facts and circumstances test to determine the type of trust involved and the validity of the trust?

3. Whether a revenue agent should be required to conduct a facts and circumstances test to determine whether a corporation has been validly established under corporate law and that the corporate form is being honored by the shareholder where the Schedule K-1 indicates that a partner is a single shareholder corporation?

CONCLUSIONS

1. A revocable trust should not be disregarded for purposes of determining whether a partnership qualifies as a small partnership for purposes of section 6231(a)(1)(B) notwithstanding the fact that the grantor of the trust is considered to be the partner for income tax purposes pursuant to sections 671 and 676. Accordingly, a partnership will not qualify for the small partnership exception because the trust is considered a partner for purposes of the unified examination and litigation procedures of sections 6221 through 6233.

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2. The Service should conduct a facts and circumstances test solely to determine whether a trust has been validly established under state law. A facts and circumstances test should not be conducted to determine whether the trust falls within one of the provisions set forth in sections 671 through 679.

3. The Service should conduct a facts and circumstances test to determine whether a corporation has been established under state law for purposes of determining the accuracy of information reported on Schedules K-1. If a corporation has been validly formed, the Service cannot "pierce the corporate veil" for purposes of determining the small partnership exception of section 6231(a)(1)(B).

#### FACTS

[REDACTED] was a partnership consisting of two general partners during the taxable year ended [REDACTED]. The general partners are [REDACTED] and [REDACTED]. The Schedule K-1 attached lists a social security number as the partner's identification number rather than the trust's identification number. Item C on the trust's Schedule K-1 indicates that the entity is a trust. Additionally, the trust is designated as the tax matters partner ("TMP") on the partnership return.

#### DISCUSSION

##### I. Grantor Trust as Partner.

I.R.C. § 6231(a)(1)(B) excepts "small partnerships" from the unified examination and litigation procedures of sections 6221 through 6233. A small partnership is defined as a partnership with 10 or fewer partners, each of whom is a natural person (other than a non-resident alien) or an estate. In addition, each partner's share of each partnership item must be the same as his share of every other partnership item.

The issue in this case is whether [REDACTED] is a natural person, thereby satisfying the first requirement of the small partnership exception set forth in section 6231(a)(1)(B)(i)(1). We believe that if [REDACTED] was a valid entity for state law purposes, it should be recognized as a valid entity and partner for purposes of the TEFRA procedures notwithstanding the fact that the grantor of the trust is considered to be the partner for income tax purposes pursuant to sections 671 and 676.

The provisions of sections 671 and 676 transfer the tax effects of the grantor trust income, deductions, and credits to the grantor because of their retention of control over the trust. However, the status of the trusts as legal entities under state law is not altered by the section 671 deemed transfer of the stated tax effects. Cf. Helvering v. Clifford, 309 U.S. 331 (1940). Consequently, the grantor trust is a partner in Sobrato [REDACTED] regardless of its treatment under sections 671 through 679.

As noted above, in order for a partnership to fall within the small partnership exception, the partnership must have only "natural persons" or estates as partners. I.R.C. § 6231(a) Since the [REDACTED] is a partner and is not a natural person, the partnership does not qualify for the small partnership exception. Therefore, the partnership is subject to the TEFRA unified audit procedures.

## II. Facts and Circumstance Test to Determine the Validity of a Trust

In the recent decisions of Z-Tron Computer Research and Development v. Commissioner, 91 T.C. 258 (1988) and Harrell v. Commissioner, 91 T.C. 258 (1988), the Tax Court set forth a "bright line test" for determining whether the same share requirement of section 6231(a)(1)(B)(i)(II) has been satisfied. The "bright line test" provides that each partner's share of each partnership item is determined by examining the partnership return and Schedules K-1 (and any amendments filed prior to the commencement of the audit), considering only those items reported for the year in issue. Special allocations under section 704(c) or allocations to reflect special basis adjustments under sections 734, 743 and 754 are not considered when determining the same share amounts. Temp. Treas. Reg. § 301.6231(a)(1)-1T(a)(3). If any disproportionate allocations are identified, a facts and circumstances test should be applied to determine if the disproportionate allocations are due to section 704(c) or because of basis adjustments pursuant to sections 734, 743 or 754.

Our position is that the bright line test is limited to determining whether the same share requirement has been satisfied (i.e., the test should not be used to determine the number of partners in the partnership or whether all partners are natural persons). Therefore, for purposes of determining whether the natural person requirement is satisfied, if the Schedule K-1 indicates that a trust is a partner, the Service should conduct a facts and circumstance test to determine that a valid state law trust has in fact been established. This test should be limited to determining whether the trust exists regardless of whether the trust falls within one of the provisions set forth in sections 671 through 679. Because a grantor trust should not be

disregarded for purposes of TEFRA, it is not necessary to conduct a facts and circumstances test to determine the type of trust involved.

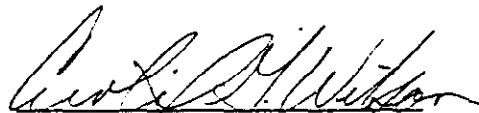
III. Facts and Circumstances Test to Determine Validity of Corporate Partner.

Your request also addressed whether the Service is required to conduct a facts and circumstances test to determine whether a single shareholder corporation has been validly established under corporate law and that the corporate form is being honored by the shareholder if the Schedule K-1 indicates that the corporation is a partner. We believe that the Service should conduct a facts and circumstances test to determine whether a corporation has been established under state law for purposes of determining the accuracy of information reported on the Schedules K-1. Once it is established that a corporation has been validly established under state law, however, the natural persons requirement is not satisfied and the TEFRA procedures should be applied during an audit of the partnership. This conclusion is not altered by the fact that a corporation listed on a Schedule K-1 was an alter-ego, nominee or sham.

If you have any additional questions regarding this matter, please contact Vada Waters at (FTS) 566-3289.

MARLENE GROSS

By:



CURTIS G. WILSON  
Senior Technician Reviewer  
Tax Shelter Branch